Public Resources Advisory Group

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Little Hoover Commission
925 L Street, Suite 805
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ATTN: David Shoemaker

RE: Roadmap for Reform

Dear Commissioners:

I appreciate the opportunity to provide brief comments for your consideration regarding the Commission's project to develop a roadmap for structural reform of the California budget process. Commission staff requested that I focus these comments on structural changes that would have a positive impact on investors in the State's bonds and other lenders to the State and therefore should result in a lower borrowing cost for the State. I offer these comments having served as financial advisor to the State Treasurer's Office since 1991 on the issuance of California general obligation bonds and revenue anticipation notes and in this capacity have had direct interaction with the State's credit rating agencies, investors and lenders.

As you are aware, during 2003 the State's credit rating was reduced by all three credit rating agencies to the lowest of any state. The State's general obligation bonds are now assigned credit ratings of BBB by Fitch, Baa1 by Moody's Investors Service, and BBB by Standard & Poor's. The credit downgrading resulted from a weak economy and the (1) failure of the State to maintain a balanced budget; (2) the magnitude of its cash and budget shortfalls; and (3) the uncertainty surrounding many of the major solutions that have been presented to solve the budget problem.

The State's low credit ratings have a real cost to Californians. It now costs the State an additional interest cost of one-half percentage point to borrow relative to the cost paid by other states. In dollar terms this can amount to hundreds of millions of dollars or more depending on the amount the State borrows to build schools and other public facilities. This higher borrowing cost is likely to continue until a balanced budget is restored and investors are satisfied that the State is on track towards fiscal recovery and it is unlikely that the recent budget imbalances will be repeated.

The credit rating agencies have written extensively on the structural impediments that are endemic to the California State fiscal structure. There are essentially four themes I believe are common in the rating agency commentaries and the State should attempt to enact reforms that address each of these areas in order to rapidly restore confidence in the State's future fiscal stability.

1. <u>Reduce the two-thirds threshold required to enact a budget</u>. The State must have the ability to take corrective action to avert budget imbalances. The tool that has been traditionally used in California is to wait until budgets are presented to the Legislature for approval. The current approval threshold almost ensures a stalemate during times of fiscal stress and prolongs enactment of fiscally responsible solutions. A lower threshold would make it easier for the Executive Office to receive approval from the Legislature of budgets that were balanced within a time frame that would hasten fiscal recovery.
2. <u>Provide ability to take immediate corrective action</u>. Constraints on fiscal management have prevented the State from taking immediate action to maintain a balanced budget. The Executive Office should be given the tools to adjust spending within a fiscal year if revenues are not meeting

projections; expenditures are growing at a faster rate than expected or for any other reason. It should not require approval of two-thirds of the Legislature to take these actions.

3. Improve budgetary reserves. The State's practice with budget reserves has been to have larger reserves when the budget situation is improving but relatively small reserves when the fiscal situation is strained. To be truly of value to maintaining budget balance, the State should maintain a reserve at a fixed percentage of the budget. The State should also consider the use of a "hard" reserve that can only be tapped under certain situations. The State's current reserve fund is a "soft" reserve because funds in the Special Fund for Economic Uncertainties are co-mingled with the General Fund and available to support General Fund spending. This makes it easy for the State to spend the funds in the reserve without addressing the underlying cause of the budget imbalance. In situations where a "hard" reserve is in place, the use of the reserve requires certain findings or Legislative approval so any use of funds in the reserve is generally accompanied with actions to restore the reserve and provide a solution to the budget imbalance.
4. Adopt multi-year budget. The State has utilized a variety of "one-time" measures, such as bond sales and deferral of payments, in order to balance budgets. These actions may produce a budget where revenues equal expenses in the budget year, but frequently exacerbate the budget problem in subsequent years. If the State were required to at least review, if not adopt, a budget that spanned more than one year, the negative impact of these one-time measures would become apparent.

I hope these brief comments are useful to the Commission in addressing this very important issue. I am confident that real action to treat these structural deficiencies in the California budget process will go a long way to restoring investor confidence in the State's fiscal management and result in a reduction in the relative cost paid by the State to borrow funds for important public infrastructure investments.

Please do not hesitate to contact me at 310-477-4278 if you have any questions or would like additional information.

Sincerely,

Wesley C. Hough
Co-President